

Gaining Firm Acceptance of a Profitability Model

By **Kris Satkunas**

As law firms grow in size, and expand geographically and across practice areas, the use of firm-wide profitability tools has become a business necessity. But understanding the urgency to adopt or update a profitability model doesn't guarantee its successful implementation.

The road to success begins with the ability to anticipate the pitfalls that may impede the process. In addition, firm managers should consider what they're seeking to learn from profitability analysis. The model they select should meet these goals and provide the data needed to move the firm's business strategy forward.

In helping deploy more than 75 profitability models over the past five-plus years, Redwood has learned that certain key components will determine how effective a model becomes in enabling a firm to improve its performance.

STEERING CLEAR OF POLITICAL ROADBLOCKS

As many a firm manager has learned, the mere introduction of profitability tools can raise concerns. There are bound to be anticipated winners — those who expect their practices to shine — as well as those who fear their practices will be deemed less profitable than desired.

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Redwood strongly recommends holding a vendor-client kickoff meeting at the beginning of the deployment process. At such meetings we've learned to look out for two groups of extremists among the finance staff. There are those who are anxious about how partners will react to profitability information, and therefore vow to keep the process secret until the model has been completely vetted. Then there are those who react to news of the development of a profitability model with glee. But their enthusiasm may be driven by reasons that are unlikely to lead to a productive process — such as the desire to “prove” to certain groups how unprofitable their work is.

A project's success depends upon convincing the first group of the advantages of being more forthcoming with information as the model is developed. The more buy-in you receive along the way, the less resistance you will have when the end product is released. The second group may need to be held

back from its urgency to ensure broad acceptance of the value of the model.

KNOW WHERE YOU'RE HEADED

Firm managers anticipating adopting a profitability model (or updating their current model) should take a look at the big picture: What is the firm seeking to learn and/or accomplish? Some goals may include:

- Understanding profitability drivers;
- Developing a tool for strategic planning;
- Creating a resource for matter planning and other tactical decisions;
- Obtaining data for the evaluation of performance versus strategic goals; and
- Providing support for compensation decisions.

Firms need not wait to implement a profitability model until they have a completed strategic plan; however, they should have a firm grasp as to what they are seeking to gain from the model. For example, a firm that has set

Figure 1: Tie the Deployment of Information to Firm Strategy

Firm Strategy – Maximize Leverage

% Partner Hours by Department

Corporate	Litigation	Tax	IP	Firm
40%	25%	50%	30%	40%

Redwood Benchmarks

33%	31%	47%	29%	32%
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the goal of better understanding profitability within the next year or two should have a different deployment plan from a firm that wants to use the model for matter planning during the upcoming year.

Resistance to certain functionalities should not be allowed to sink an entire project. The managing partner of one firm determined that while he wanted to give his partners the information they needed to make informed decisions about managing matters and clients, he did not want them to become sidetracked by the issue of attorney profitability. So even though the profitability model provided an option to create attorney profitability views, the firm chose to forego this option, at least at the outset of the deployment

PLAN FOR ACTION: LINK OUTPUT TO STRATEGY

The success of any model can be measured by its ability to spur action. Law firm partners receive a host of mixed messages concerning their practices, clients, matter management, etc. A profitability model should be designed to deliver the precise information needed to implement a firm's strategy. A profitability model also can be used to help guide strategy at the practice group level.

The first step to creating useful information is understanding the firm's strategy and gauging how far the firm is toward implementing that strategy. The managers of one firm said they wanted to focus on three things one year, one being maximizing leverage. (See Figure 1 on page 5.)

We compared the percentage of partner hours by department. At the request of the firm, we then looked at how the firm's numbers compared with our benchmarks.

The second step to using profitability figures to implement a firm's strategy is to set and communicate targets. In the leverage example, what are the firm's leverage goals? The third step is measuring the firm's success. In the example, this would involve the distribution of client/matter-level data with leverage information.

Suppose a firm has determined that it will aggressively set standard rates rela-

Figure 2: Choose Your Education Examples Carefully

	Std Amt	Direct Margin %	Revenue Drivers	Expense Drivers	
			% Revenue Gain(Loss)	Leverage Index	Weighted CI Speed
All Clients	\$10,386,590	54.9%	0%	60	95
Client 22225	\$2,273,500	54.0%	0%	57	64
Client 77374	\$2,184,971	37.8%	0%	46	80
Client 15988	\$201,234	64.0%	-1%	67	66
Client 10872	\$169,015	33.6%	0%	45	62

tive to its peers and avoid discounts that are higher than a given percentage. A well-designed profitability model can be used to manage this part of the firm's strategy. Are there times that it might be appropriate to accept a higher discount? It might be acceptable if the client's margin can be managed to a certain level.

NUTS AND BOLTS OF MODEL DESIGN

It's important to remember that a profitability model is a management tool — not an accounting system. Managers should avoid allowing the desire for numerically precise allocations to impede deployment.

Key to obtaining buy-in

is recruiting a sponsor

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Also, a profit model that includes data on matter profitability must consider partner compensation as a cost — data not maintained by firm accounting systems. These figures will need to be determined without holding up the process.

Nonetheless, to obtain a working model, developers will have to choose

their battles. At Redwood Analytics, we have strong opinions regarding certain best practices. For example, we believe firms should not use a cash basis profitability model, particularly for evaluating matter profitability. We also believe firms should use a high cost-of-capital assumption.

We no longer debate cash versus accrual — we simply don't build cash basis models, because using the accrual method is essential to the integrity of the model. However, we are more flexible concerning capital assumptions. While we haven't changed our opinion, this factor is not a key driver of matter profitability; the real cost associated with carrying inventory is embedded within the risk of uncollected cash, not in capital costs.

In addition to making methodological decisions, it's crucial to consider the types of data that do — and don't — belong in a profitability model. The figures that are fed into the model should be those needed to create results that will drive performance improvements. Unnecessary detail can make the model difficult to update and creates "white noise" that impedes analysis.

GEARING UP FOR LAUNCH

Once the model is ready to launch, the launch process needs to be carefully managed to ensure that the model's usefulness is maximized.

Key to obtaining buy-in is recruiting a sponsor for the project from the beginning. The team deploying the prof-

itability model should include a partner who participates in the development of specifications. Including a partner on the team is the best way to begin the early sharing of information concerning the development of the model. The partner should act as a sounding board, approve the rollout plan, and promote the translation of the data produced by the model into action.

Firm managers can expect, and should accept, that there will be one or more partners who will disagree with the model's output. Some may take issue with the fact that the model doesn't account for subjective factors such as matter and client management skills, business development efforts (or lack thereof), etc. Others, operating under the conviction that their practice is unique, simply may not want to be measured.

There always will be some factors that can be fine-tuned to gain additional buy-in. How much time and resources should be spent adjusting the model may depend upon the likelihood that the revisions will result in improved performance. It is essential not to be sidetracked by red herrings.

Once the model has been developed, information and recommendations resulting from implementation of the model should be rolled out incrementally to those within the firm that can and will act upon the data. Generally, this means first sharing the information with the executive committee, and then with the practice group and/or office leaders.

Leaders should have a few months to digest the data before it's passed on to those at the next level. By the time the profitability data is passed along, those who have had access to the model's capabilities should be able to demonstrate the results they've been able to achieve in moving the firm's strategy forward.

TOOLS TO LEVERAGE RESULTS

Once firm managers are confident in the design of the profitability model, the challenge becomes ensuring that its output spurs action and leads to improved performance.

One strategy to employ is to focus in the beginning on client profitability analysis. Tracking factors such as realization, staffing, growth, and inventory management in terms of profitability helps partners examine the behavior they can control, at levels that can be easily managed. These types of data are less divisive than data that's organized by attorney or by practice group.

In presenting profitability information to partners, it's important to remember that the goal of deploying such data should be to obtain incremental profitability improvements. Rather than focusing on obvious profitability variances, such as the fact that a corporate client is more profitable than a public school system client, the goal should be to demonstrate that both clients can be made more profitable by changing the staffing on the engagement or improving inventory management. Managers and partners should examine the data together to determine where there is marginal room for improvement.

In addition to focusing on the most useful data from the partners' vantage point, the model should be rolled out with a basic educational reference that helps partners tap into the power of the model. Education should be provided one-on-one and in person. The examples used to help guide partners through profitability results should be carefully chosen to make the point intended, rather than drawing a defensive response.

It's usually best to make a point with clients that are somewhat "anonymous" — *i.e.*, smaller and less familiar. Figure 2 below illustrates a \$10+ million book of business for a given billing attorney in which the second of the two largest clients has relatively low profitability because of poor leverage. Using this example likely would elicit a response from the responsible partner that the client is high profile and requires partner-level support.

But if the educator makes the same leverage point with a smaller client, such as the last client listed in Figure 2, there's likely to be less visibility and built-in knowledge about the client.

A high-level explanation of method-

ology generally is more effective than one that includes too many details. Most partners don't need — and don't want — the particulars of what was included in the overhead calculation. Some may ask for more detail, and it's fine to share with those who ask. But the majority will want the focus to remain on how they can manage their way to improved performance.

MOVING FORWARD

Once word gets out that client profitability data exist, the failure to share such data can cause concern and lead to a divisive environment within the firm.

Therefore, notwithstanding the fact that some data may be shared in stages at certain management levels within the firm, firm managers need to communicate clearly the plan for sharing the data — and then follow through on the plan.

In addition, those deploying the profit model should understand and make clear from the outset that while a powerful tool, it's not the ultimate answer to all management questions, and not a complete picture of partner performance. Certain outputs of the model are critical components of partner or practice area scorecards, but there is other information to incorporate for a robust evaluation.

The effectiveness of a profitability model is measured by its power to drive improved performance. Performance improvement is best obtained by a model that is strategically constructed and executed to gain firm acceptance and to deliver meaningful data concisely to firm managers and partners.

